Testimony of the

Pennsylvania State Education Association (PSEA)

Public Hearing Regarding

Pension Reform

Presented to the

Senate Finance Committee

April 15, 2015

By

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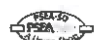

Good Morning. Chairman Eichelberger, Chairman Blake, Members of the Senate Finance Committee, I am Steve Nickol, Assistant Director for PSEA Retired Programs and a former state legislator who represented parts of York and Adams Counties.

During the 18 years that I served in the House, I served as a trustee on the board of the Public School Employees' Retirement System (PSERS) representing the House Republican Caucus. I have, in addition to my public sector experience, also served on the boards of a private defined benefit pension plan, and an insurance company that sponsors a 401(k) plan for its employees.

In my current position, I travel across the state and present a series of pre-retirement workshops for PSEA members that are focused on the PSERS retirement benefit and health options. I am also available to our members for personal consultation should they have any retirement-related questions.

I thank you for inviting me here today to express the views of PSEA on retirement security and the various proposals and issues associated with pensions currently before the General Assembly.

How We Got Here

PSERS was created in 1917; the State Employees' Retirement System (SERS) was created in 1923. These pension systems have weathered the Wall Street Crash of 1929, the Great Depression, the OPEC oil price shock of 1973, Black Monday, world wars, and a great number of other significant financial crises and recessions to successfully survive the 20th Century.

And succeed they did. At the turn of the century, PSERS and SERS were both viewed as models of success. PSERS was 123% funded, SERS was 134% funded, and the employer cost of pension benefits had dropped to 0%.

Today, 15 years later, PSERS is only 62% funded and SERS is only 59.2% funded. These two large, successful state pension systems, which have provided retirement security to millions of Pennsylvanians over the course of their existence, are now viewed by some critics as unsustainable. I feel it is incumbent on all of us to understand what went wrong, correct the problems, make any necessary changes, and restore these systems to financial health.

These two pension systems have also been tremendous economic engines for the Commonwealth. They have supported significant economic activity in many critical sectors of our state's economy either through direct investment or the purchasing power of hundreds of thousands of retired state and public school employees who are receiving pension benefits.

Under a defined benefit model, contributions are made by both the members of the pension system and their employers. The plan assets are pooled and professionally invested with the

earnings from these investments covering most of the cost of the retirement benefits. If you look back over the last 20 years, for example, you will find that investment earnings provided 71% of the funding for benefits paid by PSERS, member contributions provided another 15% and employers only provided 14% of the funding.

The members of a defined benefit system are able to slowly earn a pension benefit over a working career and are rewarded with income security in retirement. Employers benefit because they can defer a portion of employee compensation to sometime in the future and use investment earnings to offset part of the cost. This can be a win-win proposition for everyone, including taxpayers, if everyone keeps their side of the bargain.

So what happened over the last 15 years? Starting in 2001, the General Assembly intervened legislatively, increased pension benefits, which I voted against, and then proceeded to take a series of actions that cut or capped the required employer contributions necessary to sustain the pension plans.

From 2001 to 2013, Pennsylvania ranked 49th out of 50 states in meeting its annual required contributions to its pension funds. Only New Jersey ranked lower. Anyone wishing to explore these numbers in more depth might want to review an 82-page study comparing pension funding among the states that was recently released by the National Association of State Retirement Administrators (NASRA). Attached to my testimony is a NASRA press release that includes a link to the study.

The total employer funding shortfall over this period was $14.9 billion. The missing contributions were only the tip of the iceberg in terms of the impact on the pension systems. Remember that earnings from investments generate most of the funding for a defined benefit plan. In the case of PSERS, investment earnings accounted for 71% of funding during the last 20 years. Therefore, not only were PSERS and SERS short funded, but they could not earn money investing IOUs. As a result, they lost earnings that would have been generated with proper funding, which when compounded over a period of more than a decade, would have helped to sustain the pension systems.

Other factors should not be overlooked, including the investment losses of the 2008-09 Great Recession, as well as the cost of the benefit increases in 2001. Both of these contributed to the substantial swing in the fund from greater than 100% funded to having more than $50 billion in pension debt. However, both of these factors pale in comparison to the employer funding holiday, which is the single largest factor contributing to the debt.

The same NASRA study I mentioned earlier clearly demonstrates that other states with defined benefit pension systems were able to survive the past decade without a funding crisis similar in size to the one facing us in Pennsylvania or New Jersey. These other states had one thing in common: They made their required employer pension payments.

ACT 120

For years PSEA advocated for legislation that would have established a minimum floor for the pension plans' Employer Contribution Rates. Ultimately, these efforts were not successful, due in some part to the fact that the projected Employer Contribution Rate spike continued to decrease year after year. That was, until the Great Recession, when PSERS and SERS, just like every other market investor, lost a substantial portion of their portfolios. Once again, the projected contribution rate spiked to near 30%.

In 2010, PSEA was approached by legislators from both parties in the Senate and House, and my colleagues and I worked with them to try to address the impending Employer Contribution Rate spike. Over a period of months, PSEA focused its attention on reducing the cost of benefits and establishing a responsible payment plan. Ultimately, these collective efforts resulted in the passage of Act 120 of 2010. This legislation rolled back benefits for new employees to a level lower than had existed prior to the benefit changes the Legislature passed in 2001. Not only was the pension multiplier reduced to 2% but, in addition to other changes, vesting went up to 10 years, and the retirement age was increased, requiring state and school employees to work years longer before they can collect a full retirement benefit.

Most notably, Act 120 pension members share the investment risks associated with pension funding with their employers. If the pension systems suffer significant investment losses, these employees are required to make additional risk-sharing contributions to reduce the impact on employers and taxpayers.

It is important to note that while employee contributions under Act 120 remained the same, the benefits were reduced, which effectively equates to a rate increase for these same employees. The result of these changes means that new employees now carry 70% of the cost their retirement benefits. This isn't readily noticeable yet, because employers pay a blended rate that includes both pre- and post-Act 120 employees. However, if PSERS were to break out the employer cost for pension benefits earned by employees hired since Act 120, you would see that it is now less than 3% of payroll.

PSEA is not aware of a lower employer normal cost rate for new employees enrolling in any other state pension plan in the nation. If you know of one, please bring it to our attention as I would be anxious to examine it.

The Real Issue - Debt

Ultimately, PSEA and the other public employee unions agreed to these changes because the Legislature was willing to commit itself to responsibly step up funding to the pension systems and eventually pay off the pension debt.

As you can see, the current crisis, although referred to as a "pension crisis," was not really caused by the cost of pension benefits earned by school employees moving forward. These costs are presently less than one-third of the total employer contribution rate as set for next year. As Act 120 kicks in and new hires replace current members of the system, the cost of pension benefits is projected to eventually fall to less than 3%.

There has been considerable legislative debate over benefits for new hires–with various legislators proposing to put new hires in a 401(k)-style, cash balance or hybrid plan. One might think with all the debate focused on plan design that instituting such changes would make a major difference and solve the current "pension funding crisis." The fact of the matter is that all these proposals fail to address the real problem, which is the cost of paying off the pension debt that the Legislature has run up like an unpaid credit card bill over the last 15 years.

The fact of the matter is that even if you were to ask new hires to pay 100% of the cost of their own pension benefits moving forward, and require no employer contributions toward their benefits, the most the Commonwealth and school districts combined would save is 3% of payroll in 30 years as these new hires gradually replace all the current members of the pension system. This would be only a drop in the bucket toward solving the current funding crisis that will see the employer contribution rate paid by school districts peaking at over 30% within the next several years. At the same time, it would create significant problems with the Commonwealth's ability to attract and retain talented individuals within the education system.

The problem today is not a "pension crisis," but rather a "debt crisis." What options does the Legislature have to deal with this debt:

1) Accelerated payments – There are legislators who want to pay down the more than $50 billion in pension debt sooner than required under Act 120. This would indeed save taxpayer dollars in the long run, but it would also require substantially higher pension payments today and over the next decade.

2) Longer payoff period – There are other legislators who follow the line of former Governor Corbett and are willing to lower the Employer Contribution Rate over the next several years, in order to provide short-term budget relief. This would defer payments and, essentially, run up even higher charges on the credit card with future taxpayers having to pay an even larger bill. This is exactly how we got into this mess in the first place.

I mention this because critics of the position PSEA has taken in recent years, which is to let Act 120 work, really only have two options: pay more now or defer payments and run up additional charges on the credit card to be paid tomorrow. Act 120 is not perfect. This was a compromise piece of legislation and, as with any compromise, no one party achieved every policy goal they sought. The funding piece of Act 120, with the contribution rate collars, was not PSEA's

creation, but at that time PSEA was told by legislative leaders that it was crafted with budget realities in mind.

PSEA has carefully reviewed all the various pension reform proposals introduced since passage of Act 120 in 2010. These proposals all purport to address the pension funding crisis, but few of them actually do much of anything. Some play around the edges and makes changes to the benefits of people who have not even been hired, and say the problem is solved; others actually make the problem significantly worse.

Among the proposals that make the problem worse are those that close off PSERS and SERS to new hires and put them all into a 401(k)-type plan. The transition costs involved in closing off large pension plans with significant amounts of debt have been estimated by actuaries to increase costs for employers over the next 30 years by more than $40 billion. This warning was not only issued by the actuaries for the two state pension funds, but the numbers were confirmed by a neutral third-party actuarial firm that has no direct interest in the outcome.

Let me now turn for a moment to the several proposals that have been offered by Gov. Tom Wolf related to pension funding.

- The governor has proposed to move the funding for school employee retirement from a line item in the General Fund budget to a restricted receipts account. PSEA understands that this would mean that the contributions would be treated similarly to other state debt, which it is, and not be subject to legislative appropriation.

  This is a bold and long overdue move. Had it been done 15 years ago it may have prevented today's pension crisis.

- The governor has also proposed a $3 billion bond issue tied to revenues from liquor modernization to help pay down some of the current pension debt. This proposal would lower the unfunded liability of the pension systems, and by doing so lower pension costs in future years.

  PSEA is aware that liquor bonds of this nature have been passed in Maine and Ohio, although the proceeds in these states were used for different purposes - Medicaid cost reimbursements in Maine and a jobs program in Ohio.

  While PSEA supports steps to pay down the state's pension debt, it does not have a specific position on pension bonds. This is because the success or failure of any particular bond issue is largely tied to market timing. This could be a positive move if the market timing is good, but PSEA feels that it must be left to others to make this determination.

- In addition to the bond proposal, Gov. Wolf has proposed a one-time transfer of $80 million from the State Stores Fund in Fiscal Year 2016-2017 to be used to supplement the Commonwealth's reimbursements to school entities for the cost of retirement.

  The Act 120 collars will expire in 2016-2017 after the final large increase in the employer contribution rate, 3.85%. The rate in following years is only projected to increase by about 1% or even less. In fact, the PSERS rate may even begin to decline if the governor's bond proposal is approved and $3 billion of the current debt is pre-paid.

  My comments should not minimize the impact that the increase will still have in 2016-2017. It has been a tremendous challenge for school districts to build these additional costs into their budgets. An additional $80 million will prove helpful to districts in meeting this challenge, and we support the expenditure.

- Gov. Wolf has also proposed that PSERS could save billions of dollars in future years through passive investment. PSEA has strong confidence in the investment professionals at PSERS. Most of the allocation to domestic and international equities already is passively invested. If there is room to move toward passive investment in other asset classes and PSERS is able to achieve higher returns with lower fees, PSEA would certainly support it.

  The key, however, would be to have the governor's advisers sit down with the Finance Committee and investment staff at PSERS to discuss these issues. Gov. Wolf already has one representative on the PSERS Board, who can closely monitor investments and the fees paid to outside managers, and the governor will ultimately get to name two additional members of the board.

  Enacting legislation directing the PSERS and SERS Board of Trustees to invest in such a manner would be equivalent to the General Assembly assuming the fiduciary duties of the pension boards. This is a potentially dangerous precedent and very likely would tie the hands of the pension boards, result in a less diversified and perhaps riskier asset allocation, and prevent them from adapting to changing market conditions. Four of the 15 members of the PSERS Board are legislators, representative of all four party caucuses; it would seem more prudent to continue to provide input into decisions rather than make the investment decisions.

Since I just touched on the subject of the Legislature helping to create the current pension crisis, let me extend my remarks to address comments I have heard that adopting a 401(k)-type plan would take politics out of pensions.

Adopting a 401(k)-type plan would be no more successful at taking politics out of pensions than campaign finance reform was at taking money out of politics.

I am told that there have already been fights in the hallways of the State Capitol between lobbyists for large insurance companies and other corporations who are vying to administer a 401(k)-type system. Also, between lobbyists representing various financial firms who each want to be able to offer money management services and earn fees from hundreds of thousands of individual account holders.

Private companies already have begun investing in efforts to eliminate PSERS and SERS, because they stand to substantially gain should that occur. We believe they would continue to fight over the business and try to make further plan changes even if a 401(k)-style plan were to be adopted.

Beyond this, if you look to private industry, you will see that the political fights would likely continue. There is no absolute guarantee that if a 401(k)-type plan is adopted with an employer contribution rate of say 4%, that pressure will not be exerted in tight budget years to lower the rate to 3% or lower, or increase the rate in good years.

And you only need to look at our neighboring state of West Virginia to see that a move to a 401(k) is not irreversible. They made this move in 1991, and had to reverse course and reopen their defined benefit plan due to the down-the-road transition costs–similar to those referenced above in the Pennsylvania actuarial studies–they were encountering within the closed plan. In addition, West Virginia found that the balances in the 401(k) accounts of public employees were insufficient to support them in retirement.

In any case, I will conclude my testimony with the following:

- We can learn from the mistakes that have taken PSERS and SERS from full funding to more than $50 billion in debt. We need to avoid repeating these mistakes when looking for solutions.
- We can learn a lot by looking at the states who successfully weathered the last decade, including the Great Recession, with high-funded ratios and lower contribution rates than we are encountering here in Pennsylvania. We can follow their lead when looking at any alternatives.
- There is also something to be learned from the mistakes of others. West Virginia, Michigan and Alaska made major changes to their pension plans, largely based on political ideology. These changes have largely backfired, and taxpayers are now left paying a higher bill. We can learn from them and avoid false promises.

PSEA remains committed to looking at any and all possible solutions. In 2010, we were asked to be partners in the process, and we feel that Act 120 was large step in the right direction. In 2013,

PSEA was not consulted by the Corbett Administration on the pension reforms they offered, and public employees came to feel that they were under attack and responded accordingly.

I am hopeful that with a new governor, and a new start, we can successfully address these issues together.

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MOST STATES ARE FUNDING PENSIONS

Paper Describes States' Annual Pension Contributions

WASHINGTON, D.C., March 12, 2015 – Most states are meeting their commitments to fund their public employee pension funds with only a few conspicuously failing, according to a new report by the National Association of State Retirement Administrators. While having a policy requirement to annually fund a plan generally results in a higher percentage of required contributions paid in a given year, some without such a policy still consistently make adequate appropriations.

The report, "Spotlight on The ARC Experience of State Retirement Plans, FY 01 to FY 13," examines how state governments performed meeting the annual required contribution (ARC) of their public employee retirement plans. It details the ARC experience of 112 state-wide and state-sponsored public pension plans in the U.S. Together, these plans account for more than 80 percent of all public pension assets and participants.

Among the findings are:

- Policies (i.e., statutes, constitutional provisions, or retirement board requirements) that require payment of the ARC generally produced better pension funding outcomes than polices that do not require payment of the ARC; although some plan sponsors consistently paid their ARC without a requirement to do so.
- Some states that have statutory requirements still failed to fund their pension plans. Failing to make even a good-faith effort to fund the ARC increases future costs of funding the pension.
- Policy constraints that limit payment of the full actuarially determined contributions were more likely to negatively affect the ability of employers to fund the pension plan.

Even though the period of study included two economic recessions, most state and local governments increased pension contributions and maintained funding discipline to be able to provide pension benefits for former, current and future employees. However, the few states that conspicuously failed to fund their pension plans have a disproportionate effect on the aggregate experience.

The report, which was produced with support from AARP, details the ARC experience for each state and plan in the study showing that on a weighted average basis for the 13-year measurement period:

- All but six states paid at least 75 percent of their ARC.
- The average plan received 89.3 percent of its ARC.

Despite perceptions that many states have fallen far short of their pension funding requirements, in fact, most states have made a reasonable effort to fund their share of pension contributions during the period covered by this study.

The full paper is at: http://www.nasra.org/files/JointPublications/NASRA_ARC_Spotlight.pdf

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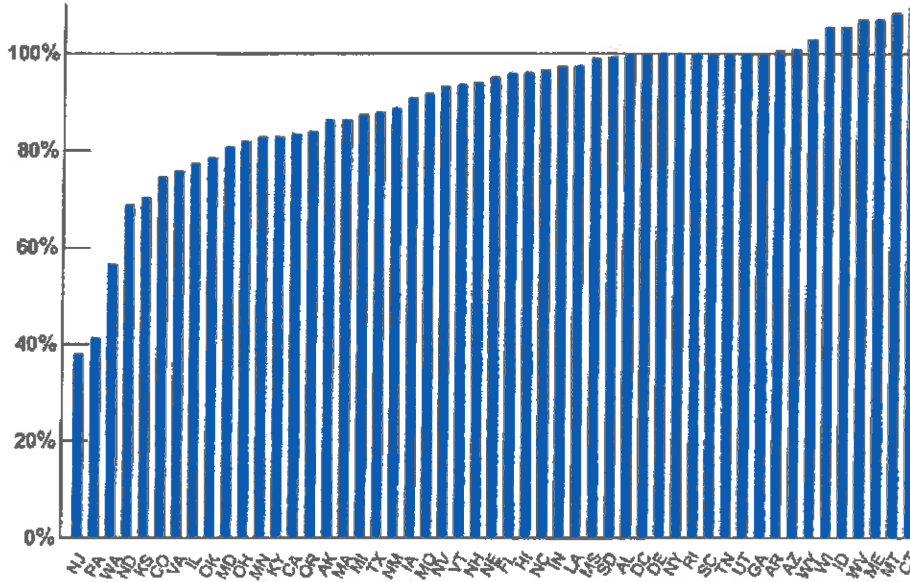
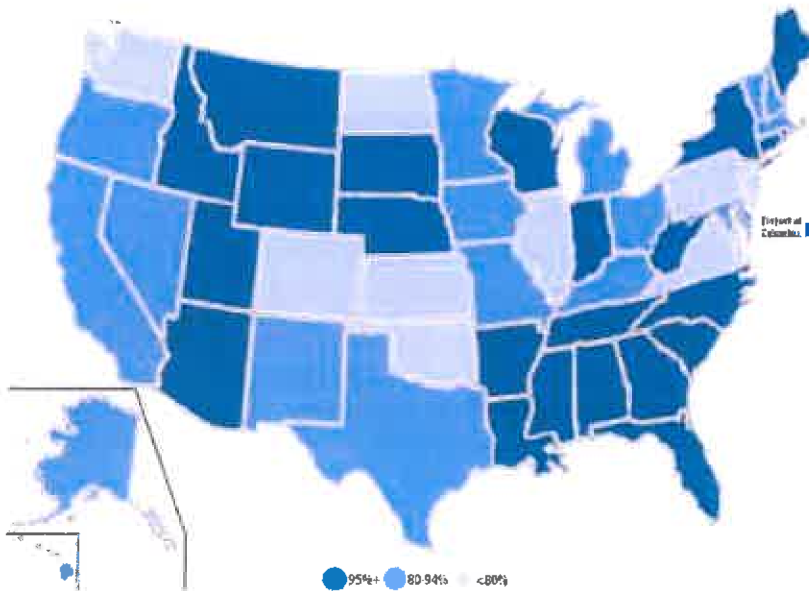


Weighted average of Annual Required Contribution paid, by state
National Association of State Retirement Administrators, 2015



Weighted average of Annual Required Contribution, paid by state
Source: *National Association of State Retirement Administrators, 2015*

The National Association of State Retirement Administrators (NASRA) is a non-profit association whose members are the directors of the nation's state, territorial, and largest statewide public retirement systems. NASRA members oversee retirement systems that hold more than two-thirds of the $3.7 trillion held in trust for 15 million working and 8 million retired employees of state and local government.

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